



Missouri Division of Finance

UPDATE

A Report of Missouri State Chartered Financial Institutions

Issue 01-02

December 2001

From . . .
Acting Commissioner
D. Eric McClure

I am proud to report that the overall condition of the Missouri State chartered banks is good. Our country and our economy have been rocked by the terrorist acts this fall. Missouri banks are facing many challenges but are positioned well with strong capital, good earnings, and most importantly, good managers. I am confident Missouri's financial industry will successfully meet these many challenges in the months to come.

Good earnings are currently being maintained but we are seeing stresses including lower net interest margins as well as higher provisions to the loan loss reserve. The ability to maintain good net interest margins is a concern. The yield curve and historically low interest rates present pricing challenges never before seen by our industry. Policies and models all need to be re-evaluated to ensure their effectiveness and validity in this new era.

I was thrilled to meet with so many of our bankers at the Outreach meetings we held around the State during October. We were honored that over 270 bankers attended these meetings. It was a privilege to travel around the State and showcase our team but more importantly to listen to the bankers' concerns and ideas. During these meetings, we outlined many of our goals and strategies at the Missouri Division of Finance, to ensure that Missouri has a safe and sound banking system. We felt these smaller regional meetings were successful and plan on doing them again in the future.

GENERAL USURY

Section 408.030 provides that the Director of Finance shall declare the quarterly market rate of interest each quarter, post it in accordance with Section 361.110 and publish it in appropriate publications. Said quarterly market rate for the period January 1, 2002 through March 31, 2002 shall be 8.3%; as an alternative, 10% may be used.

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- Safekeeping of Bank Owned Securities
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SOLDIERS' AND SAILORS' RELIEF ACT

Recent events have once again made the Soldiers' and Sailors' Relief Act (SSRA) a current topic for bankers. The original bill became law over 60 years ago to reduce the financial hardships which might otherwise have visited those engaged in the defense of our country. So far as our bankers need be concerned, upon application for relief, the lender should reduce the rate on *any pre-existing* credit to a rate which does not exceed 6% for the duration of the fighting person's active duty. "Any" and "pre-existing" are both highlighted for a reason. The credit can be for any personal, business or agricultural purpose but the rule applies only to those obligations which antedate active duty.

"Active duty" includes any basic training and, probably more pertinent to current circumstances, any time the National Guard or reserves are called into active duty; note that *voluntary* entry into military duty qualifies the person for the protection of the SSRA. The proper approach is to reduce the rate effective on the date of the orders to active duty and maintain the reduced rate for three months after separation from active duty. The bank will be contacted by the soldier/sailor who is seeking relief. The bank does, of course, have the right to see proof of the applicant's changed status. The creditor is entitled to return to the higher rate once the soldier/sailor leaves active duty but the creditor may not recover interest lost during the relief period.

Does the payment remain the same or must it be reduced? Although the SSRA does not explicitly so state (and despite a dearth of cases on point), the declared purpose of the SSRA is "to enable such persons to devote their entire energy to the defense needs of the nation". A reduction in the interest rate without reducing the payment only has the effect of shortening the term of the loan without providing any relief from the obligation to make full payments. As the SSRA does not give the creditor relief from *its* obligation to permit payment over the full contract term, common sense and a reasonable reading of the SSRA dictate that the payment is to be reduced.

The Missouri Division of Finance will not require more than a documentation of the reduction in rate along with the request for relief. There is no **need for a formal change in the contract accompanied by the soldier/sailor's signature.**

TERRORISM NET



Since the tragic September 11th attacks on our nation, Federal law enforcement authorities have undertaken a massive effort of locating and blocking assets of parties with suspected links to terrorists. Banks, savings institutions, and trust companies play a vital role in this endeavor. The FBI and Department of Treasury's Office of Foreign Assets Control have issued lists of names of suspected terrorists and blocked individuals and organizations. These listings are frequently updated as the investigation continues and can be easily accessed on the internet at <http://www.treas.gov/ofac>. Please check it regularly. The FDIC will also provide lists of entities under investigation and requests notification of positive hits by e-mail to suspicious.accounts@ny.frb.org.

Institutions should file Suspicious Activity Reports with the Treasury Department's Financial Crimes Enforcement Network (FinCEN) regarding any suspicious transactions. FinCEN maintains a 24-hour hotline at 1-866-556-3974 for immediate reporting.

Senior management is reminded of the responsibility to assure internal systems are in place to continually search for and identify suspect accounts and activity. Examples of records to check include deposit accounts, loans, trust accounts, letters of credit, trade acceptances, negotiable instruments, checks, contracts, or anything of tangible or intangible value.

SAFEKEEPING OF BANK OWNED SECURITIES

The Division of Finance is aware of several recent incidents where bank investments held for "safekeeping" may be in jeopardy. In one case, *Bentley Financial Services, Inc., and Entrust Group* allegedly sold fraudulent FDIC insured CDs to investors with an affiliated firm acting as the safekeeping agent. With the broker now in receivership, investors must file claims with the hope of gaining recovery. In the other case, securities broker/dealer, *MJK Clearing, Inc.*, was forced into bankruptcy with the Securities Investors Protection Corporation (SIPC) taking control of the firm. Securities held for the accounts of banks are not protected by SIPC insurance. Banks with securities held by the firm are now awaiting word on the extent of any loss forthcoming.

These episodes point to the need for bank officers and bank examiners to review safekeeping agreements and receipts for bank owned investments. Traditional safekeeping agreements are custodial accounts that restrict the holding firm from using customer assets for pledging or lending transactions. Banks have many options regarding safekeeping services including correspondent banks, federal agencies, and broker/dealers with safekeeping departments. While risk from fraud or financial failure can never be eliminated, the use of a well-known third-party custodian can reduce the bank's risk exposure.

APPROVAL STILL REQUIRED TO PURCHASE PROPERTY FOR BANKING USE

There has been some confusion on whether banks are still required to obtain prior approval from the Division to purchase property (land or buildings). While new legislation provides that a greater percentage of capital can now be invested to remodel or expand existing property, prior approval to purchase the property is still required. The only exemptions to this rule are those banks with more than \$200,000,000 in total assets. They may purchase property, up to the amount of their legal loan limit, without prior approval as long as there is no insider involved in the transaction.

The Commissioner's Interpretive Letter issued October 3, 2001 is specifically directed to those qualifying banks who wish to remodel or expand premises already owned and allows

an investment in the project, of up to 75 percent of capital and reserves, without seeking prior approval. Prior to this, a bank was only allowed to invest up to a maximum of 50 percent of capital in such a project, without seeking prior approval. This now means a qualifying bank can remodel or increase the size of an existing building without prior notice, as long as total fixed assets do not exceed 75 percent of capital and reserves. But it does not mean the bank can automatically purchase additional land. So, if your remodeling or expansion project involves the need to purchase additional land or a building, you must request prior approval from the Division to make the purchase unless your bank is exempt because of its asset size.



CHANGING HOURS OR CLOSING



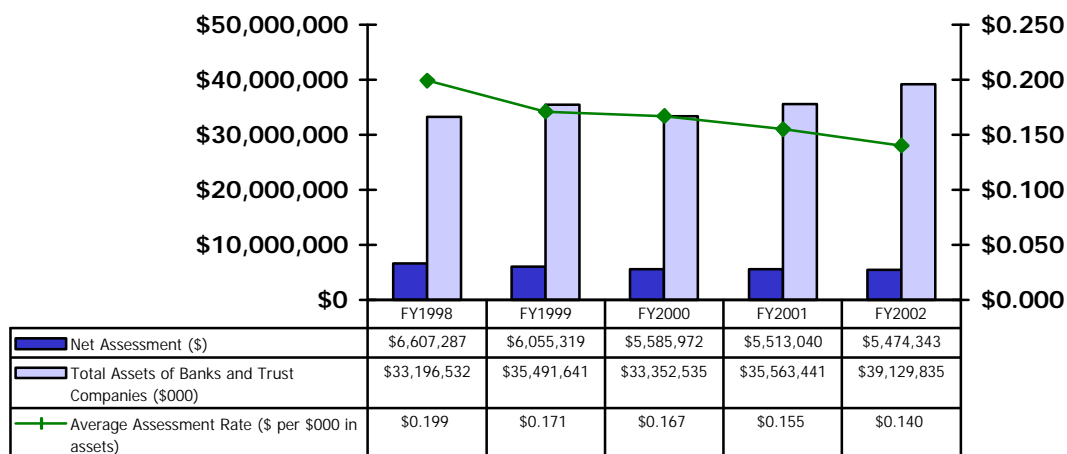
Business Hours: This time of year many institutions modify business hours to better serve customers or accommodate employees. A change in banking hours does not require notice or approval by bank regulators; however, we always encourage that customers be afforded several weeks' notice of the change to avoid confusion.

Closings: Banks usually close on public holidays such as Christmas and New Years Day. Some institutions will opt to close on days around holidays. Per Section 362.520 RSMo, the board will need to pass a resolution authorizing the closing at least 15 days in advance, with customer notice posted in the institution for the same time period. No approval by or notice to regulators is required in this circumstance. Inclement weather may also force closure of the main bank or branches unexpectedly. The statute also addresses emergency closings. In this event, a bank official should notify the Division of Finance by letter, fax, telephone or email within 12 hours of closing any location. If unable to reopen within 24 hours, officials must contact the Division for permission to remain closed for a longer period. A full report of any emergency closing must be subsequently provided to the Division.

ASSESSMENTS

Our goal is to provide state-chartered financial institutions with high quality services at a reasonable cost. The vast majority of our funding comes from assessments paid by banks and we are proud to report that the net assessment and average assessment rate have both declined every year since fiscal year 1998. While consolidation has contributed to the reduction in the net assessment, we also believe examination efficiencies have enabled the Division of Finance to help achieve our goal of reducing costs. The accompanying chart shows, for the last five fiscal years, the net assessment, total assets of Missouri state-chartered banks, and the average assessment rate per \$1,000 in assets.

Missouri Division of Finance - Bank Assessment Rate Trend

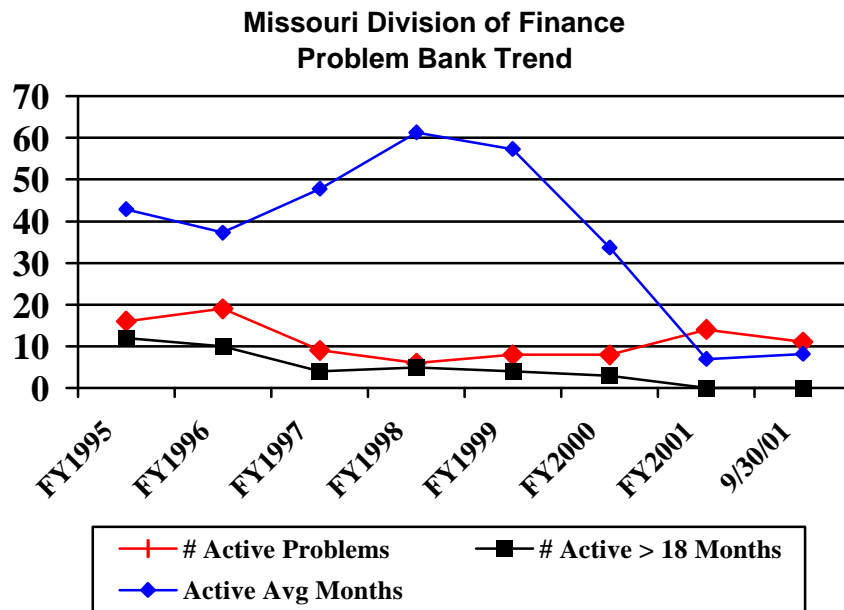


PROBLEM BANKS

The number of problem banks (those with composite CAMELS ratings of 3 or worse) has been low for several years. A significant increase early in 2001 raised the number of problem banks near our desired maximum of 15; however, as of September 30, 2001, the number reduced and stood at 11.

We not only strive to maintain as few problem institutions as possible but, more importantly, hope that when an institution does have problems, they are addressed in a reasonable period of time in order to expedite the bank's return to satisfactory condition. We believe most problem banks should be able to return to satisfactory condition within 18 months after being identified and this is a goal considered by our examination staff when performing follow-up contact on problem institutions in the form of visitations and other monitoring techniques.

As the accompanying chart displays, the average number of months that problem institutions have remained in problem status, has declined markedly since fiscal year 1998. Of the 11 problem banks existing on September 30, 2001, the average length of time in problem status was only 8.2 months.



Internal Controls

General Ledger Suspense Accounts

Most general ledger accounting systems include a low profile account buried in other assets or liabilities called a "Suspense Account". Suspense accounts are often labeled such things as: Unposted Debits and Credits, Undistributed Debits and Credits, or Miscellaneous Accounts Receivable. Suspense accounts serve to temporarily warehouse accounting entries pending classification and transfer to the proper account. Usually only one side (debit or credit) of the original entry is known and the other side (debit or credit) is placed in the suspense account to allow a forced balance of the general ledger until the item is researched for final disposition. These entries originate from a variety of sources such as remittances, branch clearing transactions, ATM transactions, and payroll transactions.

Suspense accounts are a necessity of accounting systems, but if not properly controlled, can become a dumping ground for unclassified entries and a likely target for internal fraud. For instance, an unscrupulous employee may offset deposits into a checking account with a debit to a suspense account. Once fraudulent entries are entered into a suspense account, they could remain undetected if open (i.e., unresolved) items in the account are not systematically reviewed and reconciled in a timely manner. Bona fide entries to the account that are allowed to mount and grow stale signal a breakdown in internal controls and validity of the general ledger accounts.

The activity or volume of a suspense account can be deceptive if you only consider the absolute balance of the account. The balance is actually net of numerous open debits and open credits. Consider that a suspense account with a debit balance of \$1,000 could be composed of 150 unposted debits of \$500,000 and 200 unposted credits of \$499,000. Another deceptive practice is "rolling" entries. Rolling

is accomplished by making an entry to reverse the original suspense item debit or credit so it appears cleared, but then re-posting the same amount so it looks like a new entry. This can be further camouflaged by splitting up the dollar amount of the entries or using several suspense accounts. Here are a few tips to avoid such problems:

- ◇ Document the acceptable use of general ledger suspense accounts and communicate to appropriate employees.
- ◇ Require the accounts be reconciled at least monthly. Reconcilements should be in writing and conducted by someone who has no authority to make entries to the account.
- ◇ Establish aging standards for the number of days an open item can remain in the account. Items still outstanding after 30 days should be referred to a supervisor level employee for attention. Items outstanding 90 days should be reported to senior management. Normally, open items are written-off after 90 days.
- ◇ Rolling of entries within or among suspense accounts should be prohibited.
- ◇ Ensure adequate segregation of duties and audit. The initiator of a transaction should never record entries to the suspense account. The person who records entries to the account should never be allowed to reconcile the account. The scope of audits should include suspense accounts.

Sources:

American Institute of Certified Public Accountants. *AICPA Audit and Accounting Guide, Banks and Savings Institutions*. New York: AICPA, 1996.

Smiechewicz, Walter J. "The Suspense Could Kill You! Devise a Logical Examination Process to Find Fraud Committed Through General Ledger Suspense Accounts." *The White Paper* Online. Internet. Oct. 2001. <http://thewhitepaper.com>.

REMINDER LIST

ANNUAL ACTIONS FOR STATE LAW

Division of Finance

State of Missouri

362.044 RSMo Annual Stockholders' Meetings

- ❑ Hold within the State of Missouri as prescribed in bank's bylaws. If absent such provision, must be held at the main banking house.
- ❑ Annual meeting conducted on date fixed in bylaws, or, if not so fixed, then on the second Monday of January (January 9, 2002).
- ❑ Refer to statute for notice/waiver requirements.

362.270 RSMo Organizational Meeting of Directors

- ❑ Hold within 30 days of the annual stockholders' meeting.
- ❑ Elect a director as chief executive officer. The CEO may be designated as president or other appropriate title. If the CEO is not named president, then another officer must be named president to comply with various laws.
- ❑ Elect one or more vice presidents.
- ❑ Elect other officers as required by the bylaws.

362.245 RSMo Board of Directors Qualifications

- ❑ Majority of directors must reside in Missouri or within 100 miles of the main banking house.
- ❑ All non-Missouri residents must file consent to service form with bank president, regardless of whether they live within 100 miles of main banking house.

362.250 RSMo Oath of Directors

- ❑ Every director must qualify within 30 days of election by filing an oath of office with the bank.
- ❑ Completed oaths must be immediately transmitted to the Commissioner of Finance.

362.340 RSMo Employees to Give Bond

- ❑ Board shall require sufficient fidelity bonds on all active officers and employees.
- ❑ Bond must be approved by board and noted in the board minutes at least annually.
- ❑ Bonding amounts shall be reported to the Commissioner of Finance and are subject to approval.

BANKING PERFORMANCE - 2001

Missouri state chartered banks continue to exhibit growth faster than the general economy. As of September 30, 2001, 306 state chartered banks held \$40.9 billion in assets and \$33.7 billion in deposits. This represents a growth of 9.5 percent since September 30, 2000 when 314 banks held assets and deposits of \$37.3 billion and \$30.8 billion. During the preceding twelve months, eight banks left the state banking system through merger or consolidation. The remaining 306 banks enjoyed a growth rate of 12.3 percent.

It is likely that much of the growth has been derived from shifting investments as many sought a safe harbor from the declining equity markets. A considerable portion of this new growth has been maintained in fairly liquid investments as federal funds, held to maturity securities and interest-bearing deposits reflect a growth of \$1.7 billion.

Selected performance measurements of Missouri state chartered banks include:

	Missouri State Banks	
	September 30, 2001	September 30, 2000
Yield on Earning Assets	7.78	8.00
Cost of Funding Earning Assets	3.94	3.98
Net Interest Margin	3.84	4.02
Loan Loss Provision to Average Assets	0.25	0.21
Return on Assets	1.11	1.20
Net Charge-offs to Loans	0.20	0.10
Non Performing Loans to Total Loans	2.25	2.08
Tier 1 Leverage Ratio	9.52	9.27
Loans to Assets	68.90	70.62
Earning Assets to Total Assets	92.57	93.55

Missouri state chartered banks continue to be in good condition. 95 percent of all state-chartered banks continue to be profitable as of September 30, 2001 and of the sixteen unprofitable banks, six are recently chartered. Only eight state-chartered banks are currently subject to formal enforcement actions.